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Supreme Court of the United States

HARRY H. NEUBERGER,

Petitioner,

—*vs.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

WALTER MENDELSOHN
WILBUR H. FRIEDMAN
JACOB P. ARONSON

September, 1940.

New York Appeals Co. Inc. 38 Ferry St.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

Opinions Below.

The opinion of the Board of Tax Appeals (R. 20-23) is reported in 37 B. T. A. 223. The opinion of the Circuit Court of Appeals (R. 46-47) is reported in 104 F. (2d) 649.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on June 12, 1939 (R. 46). A petition for rehearing was denied on June 28, 1939 (R. 51). By order signed September 26, 1939, the time to file a petition for certiorari was extended sixty days (R. 54). The petition for certiorari was filed on November 21, 1939 and was granted on May 27, 1940, limited to the second and third questions presented (R. 55). Jurisdiction is conferred on this Court by Section 240(a) of the Judicial Code, as amended by the act of February 13, 1925.

Questions Presented.

(1) Whether Section 23(r) of the Revenue Act of 1932 precludes petitioner, engaged in the single business of trading in securities for his own account and for the account of himself and another as partners, from offsetting his individual non-capital* security losses against his pro rata share of the partnership's non-capital security gains.

(2) Whether Section 23(r) is constitutional if construed to deny such offset.

Statutes Involved.

These are set forth in the appendix, *infra*, pages 51-58.

Statement.

The facts were stipulated (R. 12-19). From them the Board of Tax Appeals found in substance as follows (R. 20-22):

Petitioner, an individual, resided in New York. He was a floor member of the New York Stock Exchange, engaged in the business of trading in securities. He executed orders for his own account, for the account of Hilson & Neuberger, a partnership of which he was a member, and for customers of his firm.**

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* Defined by §101 of the 1932 Act to mean securities held less than two years.

** As appears from the stipulation of facts, petitioner's activities were part of a single business of security trading. Paragraph 7 of the stipulation reads in part (R. 14):

"During the year 1932 petitioner was a member of the New York Stock Exchange, and spent practically every working day

During 1932, the taxable year in question, petitioner sustained a net loss from his individual trading in stocks and bonds which were not capital assets (as defined in Section 101 of the Revenue Act of 1932) in the aggregate sum of $25,588.93. In the same year the firm derived a profit of $142,802.29 from the sale of stocks and bonds which were not capital assets as defined in the said Act. It had other income of $170,830.65 and deductions of $203,981.78, or a net income of $109,651.06[.16]. Petitioner's distributive share of said profits amounted to $36,000 of the first $94,000, and 45% of the remainder.

On his 1932 return, petitioner sought to offset his individual loss of $25,588.93* from trading in non-capital securities against his share of the partnership's non-capital security profits (R. 15, 19). The Commissioner determined a deficiency of $9,021.24 in petitioner's 1932 income tax, resulting mainly from the disallowance of said offset (R. 7-10).

Petitioner sought review by the Board of Tax Appeals urging that the offset was proper, and that Section 23(r) of the 1932 Act was unconstitutional if construed to deny the offset (R. 3-5). The Board upheld the Commissioner, following the decision of the Second Circuit in *Johnston* v. *Commissioner,* 86 F. (2d) 732 (R. 20-23); but since it found for the petitioner on other issues, and since the petitioner

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of the year 1932 on the floor of the Exchange, trading for the account of his firm (Hilson & Neuberger), executing orders on behalf of customers of said firm, and trading for his individual account."

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*This item is shown on the return as $27,096.88, but was adjusted by agreement of the parties to $25,588.93 (R. 12). In the event of a reversal, further adjustment will be necessary by reason of the Board's action in allowing stamp taxes and sales commissions as deductions.

had made part payments on account of the deficiency while the case was pending in the Board, the decision was that there was an overpayment of $824.10 in 1932 income tax (R. 24).

Cross-appeals followed to the Second Circuit Court of Appeals (R. 25-29, R. 34-39). That Court affirmed the Board with respect to the issues presented by petitioner's appeal in a *per curiam* opinion, citing its prior decisions in the *Johnston* case and in *Davis* v. *United States*, 87 F. (2d) 323 (R. 46-47). A petition for rehearing (R. 48-51) was denied without opinion. The questions involved in the Government's appeal to the court below are not before this Court.

Specification of Errors To Be Urged.

(1) The court below erred in holding that petitioner, who was in the business of trading in securities, could not offset losses from the sale of non-capital securities owned by him individually against profits from the sale of similar securities owned by him and another as partners.

(2) The court below erred in holding that Section 23(r) of the Revenue Act of 1932, construed to prevent such offset, was constitutional as applied to a case where the taxpayer's business activities in trading for his own account and for the account of the partnership against whose profits he seeks to offset his losses were interwoven into one continuous course of business. Construed as it was by the court below in this case, Section 23(r) is so unreasonable and arbitrary as to violate the due process clause of the Fifth Amendment.

SUMMARY OF ARGUMENT.

I.

Section 23(r) of the Revenue Act of 1932 permits losses on the sale of securities held less than two years (non-capital securities) to be deducted only from profits on the sale of similar securities. We contend that, under this Section, petitioner is entitled to offset his individual non-capital security losses against his share of his partnership's non-capital security profits, by reason of the general principle which pervades all the Revenue Acts from 1913 to 1932 that items of partnership income retain the same character on individual partners' returns as they had on the partnership return.

In the interpretation of the 1913 Act, the Treasury ruled that items of partnership income could not be traced to their source behind the partnership for the purpose of claiming credit for such items on individual partners' returns. Congress was not satisfied with this interpretation, and in the 1916 Act, specifically gave credit to partners for those partnership items which the Treasury had ruled did not retain their identity on partners' returns. As to other items, the Treasury first ruled that they did not retain their identity, arguing that *expressio unius est exclusio alterius.* But in 1919, the Sixth Circuit having held in *United States* v. *Coulby,* 258 Fed. 27, affirming 251 Fed. 982, that under the 1913 Act items of partnership income retained their identity on partners' returns despite the absence of any such provision in the statute, the Treasury published the District Court's opinion as a Treasury decision. It has since repeatedly followed the *Coulby* case under later Acts, thereby abandoning the *"expressio unius"* rule of construction as applied to items of partnership income not specified in the statute.

Beginning with the 1916 Act, Congress has from time to time provided that specific items of partnership income retain their identity on partners' returns. In three instances where the 1928 and 1932 Acts made no such specific provision, the Treasury, applying the rule of the *Coulby* case, ruled that partners could treat such items as having the same source as they did to the partnership. Such action can be explained only as a recognition of the existence of the underlying general principle for which we contend.

It follows that, in carrying over the partnership sections of the 1928 Act verbatim into the 1932 Act, Congress reenacted the general principle, and petitioner is entitled to the offset in question, unless Section 23(r) of the 1932 Act requires a contrary result. The legislative history of that Section shows that it was intended only to prevent the deduction of speculative security losses from salaries, dividends, rents and similar income. No intention appears to prevent a member of a partnership from offsetting his individual non-capital security losses against his share of partnership non-capital security gains. In view of the well settled general principle, a clear expression of intention was necessary to effect such result.

Petitioner's contention as to the meaning and effect of Section 23(r) is supported by subsequent enactments. In 1933, to remove what it then considered an evil, Congress amended the partnership sections to deny to partners deduction of their shares of partnership non-capital security losses. No change was made as to partnership non-capital security gains, and the clear inference from the legislative history is that Congress thought that under the 1932 law, both non-capital gains and non-capital losses of partnerships retained their character on partners' returns.

The Treasury and the court below in *Johnston* v. ~~United States~~ Commissioner, 86 F. (2d) 732, Swan, *J.* dissenting, in holding that under the 1932 Act, partnership non-capital security gains do not retain their identity on partners' returns, exhumed the rule of construction, abandoned in 1919, that the specific mention in the statute of certain partnership items which do retain identity on partners' returns, excludes all others. In the 1938 Act, the first general Revenue Act following this decision, Congress expressly provided that "short-term" (i.e., non-capital) security gains retain their identity on partners' returns, the provision being described as "a logical corollary of the principle that only the partners as individuals, not the partnership as an entity, are taxable persons." As the corollary was no more logical in 1938 than in 1932, it is clear that Congress had at all times intended that the general principle should apply to partnership non-capital security gains.

If there be any uncertainty as to the construction of the statute, it should be resolved in petitioner's favor since grave constitutional doubts result from a contrary construction.

II.

If Section 23(r) is construed to prevent the offset in question, it is unconstitutional because it discriminated against petitioner in two respects entirely unrelated to the purpose which Section 23(r) was intended to accomplish:

1. The offset was permissible against individual non-security gains, but not against a taxpayer's share of partnership security gains. The Committee reports disclose no intention to penalize members of partnerships, and had they done so, there would have been no justification for such discrimination.

2. Traders in all types of assets other than corporate securities were permitted to deduct from ordinary income their losses on such other assets held less than two years. Only traders in corporate securities were penalized by Section 23(r). Except perhaps in the case of Government bonds, the Committee Reports disclose no excuse for this discrimination and none exists.

Constitutional questions are questions of degree. It is most unfair to tax petitioner on the profits from a security trading business without allowing as a deduction therefrom losses on security transactions in the same business.

POINT I.

Under the Revenue Act of 1932, petitioner, engaged in the single business of trading in securities on his own account and as a member of a partnership, may offset his individual losses from the sale of non-capital securities against his share of partnership gains from the sale of non-capital securities.

In 1932, petitioner's individual trading in non-capital securities (securities held less than two years) on the floor of the Stock Exchange resulted in net losses. In the same year, his partnership's trading in similar securities resulted in profits, petitioner's distributive share of which exceeded his own losses.

The question is whether petitioner may offset the losses against the profits, as he could without doubt if the profits had been realized by him individually; or whether the fact that the profits were earned by his partnership

rather than by petitioner individually requires the imposition of an income tax on the full amount of the profits without regard to the losses.

Both Section 23(r) of the Revenue Act of 1932, providing that losses from sales of non-capital securities shall be allowed only to the extent of gains from sales of such securities, and Supplement F of the 1932 Act, providing for the treatment of partnership income, are silent as to whether partnership non-capital security gains retain their identity in partners' hands for the purpose of offset of partners' individual security losses.

We contend that, pervading all the Revenue Acts from 1913 to and including 1932, there is a broad general principle that items of partnership income retain their identity in partners' hands in the absence of specific statutory provision to that effect, and that, therefore, petitioner's individual non-capital security losses may be used to offset his share of partnership non-capital security gains. From 1919 on, this general principle was accepted and applied by the Treasury in its administrative interpretations, with only two recent exceptions which are discussed *infra* pp. 29-31, 35.

We contend further that the legislative history of Section 23(r), and subsequent Revenue Acts, demonstrate conclusively that Section 23(r) was not intended to create an exception to this principle. The purpose of Section 23(r) was merely to prevent the deduction of non-capital security losses from salaries, rents, dividends and other similar income; not to prevent the offset of such losses against a distributive share of partnership non-capital security gains (See *infra* pp. 24-27).

The Treasury and the court below maintain that the specific reference in Supplement F of the 1932 Act to par-

ticular types of income which do retain their identity in partners' hands requires the conclusion that other types of income, not therein mentioned, do not retain their identity; in other words, *expressio unius est exclusio alterius* (*infra*, pp. 29-31).

Thus the question may be restated as follows: Is this a case, like *Helvering* v. *Clifford*, 309 U. S. 331, and *Helvering* v. *Hallock*, 309 U. S. 106, covered by a broad general principle of the Revenue Act, specific applications of which by particular provisions of the tax law do not limit the general rule; or is this a case not covered by a general principle, so that if petitioner does not fall within the express narrow provisions, he must fail on the construction question?

In determining this question, it is not important that for limited purposes a partnership has been held to be an entity.* The question here is whether income received by the partnership, and required to be reported by the partner, remains the same type of income on the partner's return as it was on the partnership's. For this purpose neither Congress, nor a majority of the Federal Courts passing on the question, nor the Treasury (at least from 1919 to 1935) have treated the partnership as an entity.

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* Cases cited by the Government on the point that the partnership is an entity are discussed in the footnote, *infra*, pp. 23-24.

For the reason stated in the body, this brief will not discuss every instance where a partnership has been held not to be an entity. One such striking instance is the Treasury's refusal to treat salaries paid to partners as being other than distributions of partnership profits, on the ground:

> "'A partner receiving a salary is merely transferring money from one to another of his own pockets.' (*Leo Schwartz* v. *Commissioner*, 7 B. T. A. 223.)" G.C.M. 13771, XIII-2 C.B. 229, 230 (1934); G.C.M. 21418, 1939-2 C.B. 249, 250 (1939).

The Origin of the Principle that Items of Partnership Income Retain on Partners' Returns the Same Character They Had on the Partnership Return.

The first income tax law contained the following provision (Section D of the 1913 Act):

> That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, * * *.

Section B of the statute provided that Government bond interest received by individual taxpayers was exempt from tax, and that dividends received from taxable corporations were exempt from normal tax.

The statute was silent as to whether these benefits were obtainable by taxpayers who received such interest or dividends through the medium of a partnership.

Thus under the very first income tax act, the question was posed whether there is a broad general principle that items of partnership income retain their identity in partners' hands, or whether in the absence of specific provision to that effect such items lose the character they had on the partnership return.

The inferences drawn by the Treasury from the silence of the statute were conflicting.

In a letter dated April 22, 1915, the Treasury ruled, in response to an inquiry as to the deductibility by partnerships

from their gross income of the amount of exempt interest received by them, " * * * that partnerships are permitted, in a computation of their net incomes for the purpose of ascertaining the distributable interest of partnership members, to deduct [such] item * * *." A similar ruling was issued early in 1916.*

On June 1, 1916, these rulings were superseded by T.D. 2337 (Vol. 18, Treas. Dec. Int. Rev. (1916) p. 79), which stated:

> The provisions of the law relating to the exclusion of income derived from interest upon National and State obligations and to the exclusion, for the purposes of the normal tax, of income derived from dividends, are applicable to income accruing to individuals and not to income accruing to partnerships, as such.

After referring to the omission from the 1913 Act of provision for exclusions from partnership income, T.D. 2337 continued:

> "the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise," is subject to tax in the character of income derived from the partnership as the source, whatever its character may have been when it accrued to the partnership itself, and * * * the net distributive interests on which the individual members are liable for tax should include their proportionate shares of the profits of the partnership derived from [Government bond interest and dividends] * * *.

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*The texts of both rulings appear in Montgomery, Income Tax Procedure, 1917 Ed., p. 108.

> All rulings and decisions in conflict herewith are hereby superseded and overruled.

Congress was not satisfied with this interpretation. Section 8(e) of the 1916 Act gave partners credit against normal tax for their proportionate shares of dividends received by the partnership, and excluded from their gross incomes their proportionate shares of the firm's exempt income.

Thus T.D. 2337 was nullified as to the points which it expressly covered (dividends and exempt interest). But the Treasury preserved its reasoning as to items not specifically covered by the 1916 Act. In Article 30 (par. 213) of Regulations 33 (Rev. Ed. 1918), the Treasury provided that, except for dividends and exempt bond interest, partnership income "can not be traced to its source behind the partnership for the purpose of claiming individual exemption."

This formalistic application of the *expressio unius est exclusio alterius* maxim was abandoned by the Treasury a year later, after the decision of the Circuit Court of Appeals for the Sixth Circuit in *United States* v. *Coulby*, 258 Fed. 27, decided early in 1919. In that case, the court affirmed, *per curiam*, a decision of the District Court holding that under the 1913 Act a partner was entitled to deduct from his income for normal tax purposes, his share of corporate dividends received by his partnership, even though there was no express provision to that effect in the Act.

The lower court had said (251 Fed. 982):

> An examination of the entire Income Tax Law convinces me that plaintiff's [the Government's] contention is erroneous. * * *

This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. The paragraph above quoted so provides [Section D *supra,* p. 11]. The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name.

It follows, from these considerations, that legally the defendant's share of the gains and profits of Pickands, Mather & Co., derived from corporations taxable on their net incomes, is to be treated as if the same had been received by him directly from the taxpaying corporations (pp. 983-984).

The Treasury acquiesced in this decision and promulgated the District Court's opinion as T.D. 2858, 1 C.B. 166 (1919). The *Coulby* case has since been repeatedly followed by the Treasury.*

The Government has conceded that, since T.D. 2858, it has in most instances accepted the principle expressed therein as the law, even under subsequent Revenue Acts.

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* T.B.R. 64, 1 C.B. 171, 173 (1919); O. 972, 2 C.B. 163, 165 (1920); A.R.M. 13, 2 C.B. 168 (1920); Sol. Op. 42, 3 C.B. 61, 62 (1920); I.T. 1576, II-1 C.B. 144 (1923); A.R.R. 2859, II-2 C.B. 159, 162 (1923); G.C.M. 2467, VII-2 C.B. 188, 192 (1928); G.C.M. 13771, XIII-2 C.B. 229, 230 (1934).

In its brief dated November 1939, in *Craik* v. *United States,* decided by the Court of Claims on February 5, 1940, 31 F. Supp. 132, the Government said (p. 78):

> In its consideration of the problem presented in this case the Court should be apprised of the fact that since the adoption of the decision of the District Court in the *Coulby* case as T.D. 2858; C.B. I, p. 166, the Commissioner of Internal Revenue, although he has never formally ruled on the subject, has in most instances accepted the principle expressed therein as the law even under subsequent revenue acts. See, however, G.C.M. 21478 reported in 1939 CCH, par. 6455.*

In the same brief the Government said of the *Coulby* case (pp. 70, 71):

> No appeal was taken from the decision of the Circuit Court of Appeals and although Article 30 of Regulations 33 was never formally withdrawn, no comparable provision appeared in regulations interpreting subsequent revenue acts. It should be noted that the *Coulby* case related to the Revenue Act of 1913 and Article 30 of Regulations 33 dealt with the Revenue Act of 1917. The trend of authorities from 1917 to 1928 was unquestionably contrary to the context of Article 30 of Regulations 33. Cf. *App. of Schwartz,* 7 B. T. A. 233; S.O. 42, 3 C.B. p. 61. The common-law rule that all partnership property belonged individually to the partners, and income when received automatically and instantaneously

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*G. C. M. 21478 held that individual gambling losses may not offset a distributive share of partnership gambling gains under the 1936 Act. The Fifth Circuit has rejected this ruling. *Jennings* v. *Commissioner,* 110 F. (2d) 945, *infra* pp. 35-36.

> became individual property of the partners, was obviously the premise upon which the Board of Tax Appeals and the Courts determined the tax matters of individual partners as late as 1928. Cf. *App. of Lloyd*, 15 B. T. A. 82.

We shall deal later (p. 23) with the question whether there was any change after 1928, the year referred to in the above quotation.

In its opinion in the *Craik* case, the Court of Claims referred to the rule that partnership income retains its identity in the partners' hands, and said (31 F. Supp. at 135):

> The Bureau of Internal Revenue has so treated partnership income for twenty years. * * *
>
> It is admitted that since this time [the decision in the *Coulby* case] partnership income has been so treated by the Bureau.*

Thus, since 1919, the Treasury has accepted the general principle that items of partnership income retain their identity in the individual partner's hands in the absence of any express provision to that effect in the statute. We contend that this principle was still in force in 1932, and was not affected by the adoption of Section 23(r) of the 1932 Act.

The Government's concession in its *Craik* brief is borne out by the income tax statutes, administrative practice, and judicial decisions, to which we now turn.

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* Sixteen years probably would be more accurate than twenty, since the first contrary ruling of the Treasury was made in 1935 (*infra*, p. 29).

Statutory and Administrative Applications of the General Rule that Items of Partnership Income Retain the Same Character on Partners' Returns as They Had on the Partnership Return.

Each of the Revenue Acts has contained a provision substantially identical to Section D of the 1913 Act (*supra*, p. 11) to the effect that partners are liable for income tax only in their individual capacity and are taxable on their distributive share of partnership profits, whether distributed or not. In addition, beginning with the 1916 Act, provisions were included from time to time affecting the treatment on partners' returns of specific types of partnership income.

These specific provisions are applications of the general rule that partnership income retains its identity on the partners' returns.

There has never been a provision in any income tax law denying to a partner the right to treat an item of partnership income as retaining the identity it had on the partnership return.

The various sections dealing with the treatment of partnership income and deductions were collected in one place for the first time in the Revenue Act of 1928, Supplement F, printed in the appendix, pages 55-57, and were repeated verbatim in the 1932 Act.

Sections 181, 182, 183 and 189 of Supplement F set forth the general rules that

(1) partnerships are not taxable, partners being liable for income tax only in their individual capacity;

(2) partners are liable for income tax on their distributive share of partnership net income, whether distributed or not;

(3) partnership net income shall be computed in the same way as that of an individual except that the charitable contribution deduction* shall not be allowed; and

(4) the partnership shall make a return stating specifically the items of its income and deductions and the amount of each partner's distributive share.

Sections 184, 185 and 186 provide that four types of partnership income retain their character on partners' returns. These are dividend income, Government bond interest, earned income, and capital gains. Sections 186 and 187 deal with the treatment on partners' returns of partnership capital losses and net losses carried over from preceding years. Section 188 gives to partners credit against their taxes for their proportionate shares of taxes paid by the partnership to foreign countries and possessions of the United States.

All these Sections are specific applications of the general principle that partnership income retains its character in partners' hands.

There are three other types of income, treatment of which on returns of individual partners is not covered by Supplement F of the 1928 and 1932 Acts.

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* Despite this provision, the Treasury ruled that each partner could deduct on his own return his proportionate share of the partnership contributions disallowed to the partnership by the statute (Art. 261(e), Regs. 74, 1928 Act, and Regs. 77, 1932 Act). This Regulation can be justified only as an application to deductions of a basic principle similar to that which we contend applies to the partnership income.

In each case, the Treasury filled the gap by applying the general rule that partnership income retains its identity in the partners' hands:

1. Section 22(b)(4) of the 1928 and 1932 Acts, read together with the Acts authorizing the issuance of certain United States obligations, provides that interest on Government bonds of a principal amount in excess of $5,000 shall be included in gross income.

The taxability of interest on partnership owned Government bonds in a principal amount exceeding $5,000 raises this question:

Suppose a partnership with two equal members owns $10,000 principal amount of Government bonds. Is each partner exempt from surtax on the interest on $5,000 principal amount of bonds, or is his exemption limited to the interest on $2,500 principal amount, his one-half of the $5,000 principal amount interest on which is exempted under Section 22(b)(4)?

A literal reading of the statute would seem to require the latter conclusion, since Supplement F contains no provision exempting partners from surtax on partnership Government bond interest income. However, the Treasury has at all times applied to this situation the general principle for which petitioner contends.

Articles 89(b) (Regs. 74, 1928 Act) and 88(b) (Regs. 77, 1932 Act) provide:

> As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership.

Hence in the example given above, each partner is exempt from surtax on the interest on $5,000 principal amount, not merely on $2,500.

In this instance the Treasury has not reasoned that *expressio unius est exclusio alterius,* although Section 184, which gives credit for normal tax, indicates that Congress was thinking of the question of taxability of Government bond interest in partners' hands.

This interpretation has been continued in the 1940 edition of the Regulations. Regs. 103, Sec. 19.22(b)(4)-5(b).

2. Sections 144(a) (1928 Act) and 143(a) (1932 Act) provide for withholding at source of a tax of 2% on bond interest paid to individuals and partnerships.

Sections 144(d) (1928 Act) and 143(d) (1932 Act) provide that income upon which tax is withheld shall be included in the return of the recipient of the income, but the amount of tax so withheld shall be credited against the recipient's income tax.

If *expressio unius est exclusio alterius,* individual partners should receive no credit for taxes withheld at source from the partnership, there being no provision in Supplement F authorizing partners to take such credit, whereas Supplement F does allow credit to partners for taxes paid by the partnership to foreign countries and to possessions of the United States.

However, the Treasury rules that partners are entitled to their proportionate shares of taxes withheld at source on income paid to the partnership.

The partnership income tax forms for 1928 and 1932 contained space for the separate listing of each partner's share of the 2% tax withheld from the partnership, and the instructions on individual income tax blanks permitted partners to take credit for their shares of withheld taxes. (Forms 1040 and 1065.)

In G. C. M. 18120, 1937-1 C. B. 151 (1937), the Treasury ruled that under the 1934 Act (Sections 143(a) and (d) of which are substantially similar to those Sections in the 1932 Act), a partner was entitled to a proportionate share of taxes withheld at source from the partnership, even though the partnership had no net income. No mention is made of the argument that, since an express reference was made to credit for taxes paid by partnerships to foreign countries and United States possessions, the omission of a reference to taxes withheld at source was deliberate. On the contrary, the ruling assumes without question that a partner is entitled to treat income received by the partnership as retaining its identity on his return.

Even though interest was merged on the partnership return with other ordinary income, and even though the partnership in question had no net income, the Treasury held that the interest retained its identity on the partner's return, saying (1937-1 C. B. at 152):

> Nevertheless, if the interest is reflected in the taxpayer's return, it is "included" therein and therefore meets the requirement of Section 143(d) [providing that the tax withheld may be credited on the return of the recipient of the interest].

This ruling has not been revoked, and represents the continuing acceptance by the Treasury of the principle that part-

nership income retains its identity in partners' hands. The 1939 individual and partnership income tax returns (Forms 1040 and 1065), and instructions attached thereto, give to partners their shares of the credit for taxes withheld from the partnership.

3. Under Sections 211 and 212 of the 1928 and 1932 Acts a non-resident alien individual is taxable only on his income from sources within the United States.

The statute is silent as to whether a non-resident alien member of a domestic partnership which has income from sources without the United States, is taxable on his share of such income, or whether he is entitled to treat his share of partnership income from foreign sources as retaining its identity, with resultant elimination of tax thereon.

In G. C. M. 13771, XIII-2 C. B. 229 (1934), the Treasury applied the rule of the *Coulby* case to this situation and held that under the 1928 Act a non-resident alien member of a domestic partnership is exempt from tax on his share of partnership income from foreign sources, despite the absence of any statutory provision to that effect.*

Here again the Treasury made no argument based upon Congress' failure to include this type of income with the others which Supplement F specifically provides should retain their identity in the hands of partners.

G. C. M. 13771 remains in force, and its continued acceptance by the Treasury is shown by the failure to seek

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* In 1936 this ruling was modified by G. C. M. 17255, XV-2 C. B. 243, in a particular not material here. The ruling re-stated the general principle that the foreign income of the partnership remained foreign in the hands of the individual partner.

certiorari in *Craik* v. *United States*, 31 F. Supp. 132 (1940), *infra* pp. 36-40, which reached the same result.

The General Rule that Items of Partnership Income Retain the Same Character on Partners' Returns as They Had on the Partnership Return Was Carried Over Into the 1932 Act.

Thus with respect to three separate items of partnership income, the Treasury interpreted the 1928 Act in the light of the general principle for which petitioner here contends.

We know of no instance during the period from 1928 to 1932 in which the Treasury took a different view.* On the contrary, in the three instances in which the 1928 and 1932 Acts made no provision for the treatment of partnership income on partners' returns, the practices adopted under the 1928 Act were continued under the 1932 and later Acts and rulings, as has just been shown.

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* In its brief in the *Craik* case, the Government cites four cases to establish that since 1928 the Board and courts have treated partnerships as entities: *Edward B. Archbald*, 27 B. T. A. 837 (1933), affd. 70 F. (2d) 720, cert. den. 293 U. S. 594; *Percy H. Johnston*, 34 B. T. A. 276 (1936), affd. 86 F. (2d) 732, cert. den. 301 U. S. 683; *W. J. Burns*, 12 B. T. A. 1209 (1928); *Lord Forres*, 25 B. T. A. 154 (1932). The *Johnston* case is discussed *infra* pp. 28-31. The *Lord Forres* case merely follows the *Burns* case.

It is immaterial in this case that for certain limited purposes partnerships are treated as entities. For the purpose of determining whether partnership income retains its character on partners' returns, neither Congress nor a majority of the Federal Courts passing on the question, nor the Treasury (at least from 1919 to 1935) have treated partnerships as entities. The cases cited do not establish that any change took place in this respect between 1928 and 1932.

Of these, only the *Burns* case was decided in 1928. There the Board held that a partner reporting on the cash basis was entitled to deduct his *pro rata* share of accrued foreign taxes of his partnership, which reported on the accrual basis. The Board pointed out that a partnership was treated as an entity for the purpose of *computation*

It follows that, in carrying over Supplement F verbatim into the 1932 Act, Congress must be deemed to have reenacted the general principle that partnership income retains its identity in partners' hands where no specific provision is made in the statute; accordingly the offset here in question was proper unless Section 23(r) of the 1932 Act was intended by Congress to accomplish a different result. Section 23(r) provides**:

> Losses from sales or exchanges of stocks and bonds (as defined in subsection (t) of this section) which are not capital assets (as defined in section 101) shall be allowed only to the extent of the gains from such sales or exchanges * * *.

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of income since to disregard such entity would result in the distortion of partnership income (12 B. T. A. at 1224). But the Board did not state and it does not follow from its holding that partnerships are entities for the purpose of changing the nature of partnership income in partners' hands. This is borne out by the *Archbald* case, *supra*. There the question was the amount of gain taxable to a partner on securities contributed by him to a partnership and sold by it at a profit. The Commissioner contended that because partnerships were not taxable, their existence must be ignored in determining the chain of ownership and that the partner's cost was therefore the basis to the partnership. The Board held otherwise on the ground that partnerships were regarded as entities for the purpose of *computing* partnership gain. In citing the *Coulby* case as a consistent holding, the Board said: "Since, then, a partnership is treated sometimes as an entity and sometimes not, its nontaxation carries no implication of the measure of its income or that of the individual partners" (27 B. T. A. at 841). The principle preserving the identity of partnership income in partners' hands was not questioned. The result urged by the Government in the *Archbald* case was brought into the statute by the Revenue Act of 1934, Sec. 113 (a) (13).

** Section 23(r)(2) of the 1932 Act provided that losses disallowed by Section 23(r) could be carried forward to the succeeding year with limitations. The carry-over was repealed by Section 218(b) of the National Industrial Recovery Act.

We challenge the Government to point to anything in this Section, or in the 1932 Act, or in the Committee Reports, that indicates Congress intended to prevent the offset of individual non-capital security losses against a partner's share of partnership non-capital security gains.

The purpose of Section 23(r) was only to prevent the deduction of speculative security losses from salaries, dividends, rents and similar income. As the Ways and Means Committee said (72nd Cong., 1st Sess., H. Rept. 708, p. 12):

> There are no provisions in existing law corresponding to section 23(r), (s), (t), (u), and (v). Many taxpayers have been completely or partially eliminating from tax their income from salaries, dividends, rents, etc., by deducting therefrom losses sustained in the stock and bond markets, with serious effect upon the revenue. Your committee is of the opinion that some limitation ought to be placed on the allowance of such losses.

The House bill forbade the deduction of any security losses (whether the security was held more or less than two years), except to the extent of security profits. The Senate Finance Committee, which limited the new provision to securities held less than two years, explained the purpose of Section 23(r) as follows (72nd Cong., 1st Sess., S. Rept. 665, p. 10):

> The House bill adopted very severe limitations upon the allowance of losses from the sale of securities, as a deductio. in computing net income. The provision was based upon a twofold policy: (1) Protecting the revenues from the growing practice of reducing tax liabilities by the sale of securities on which losses had accrued, and (2) preventing speculative losses from wip-

ing out ordinary income, which represents real tax-paying ability.

Your committee is of the opinion, however, the House bill went much further than the situation necessitated. Securities held for more than two years have been in the hands of investors. The losses they have suffered are decidedly real losses. * * * The existing limitation, that capital losses can not reduce the tax by more than 12½ per cent, is adequate protection against excessive deductions. Accordingly, your committee is of the opinion that no change in this respect should be made in the existing law.

A somewhat different situation exists with respect to losses realized from the sale of securities held by the taxpayer for less than two years. These losses should properly be permitted only as an offset against gains from securities held for less than two years. But undue hardship under existing conditions should be avoided. Your committee believes that security gains and losses should be segregated, that security losses should be deducted solely from security gains; but that security gains should not be taxed until they actually exceed security losses.

The House accepted the Senate's version. Thus the intention of Congress was only to limit the deduction of non-capital security losses to the amount of non-capital security gains, and to prevent their deduction from salaries, rents, dividends, interest and similar income. No intention appears to tax partners on their distributive shares of partnership non-capital security gains if such partners had individual non-capital security losses. In view of the well settled principle of treating partnership income as retaining its identity on the partners' returns, a clear expression of intention was necessary to deprive partners of such set-off.

It is inconceivable that Congress would change the general rule applicable to partnership income in a fashion as indirect as adopting Section 23(r) without mentioning partnerships in the Committee Reports and without amending Supplement F, containing the partnership sections.

Petitioner's Interpretation of the 1932 Act Is Confirmed by Section 218(d) of the National Industrial Recovery Act.

When in 1933 Congress sought to change the treatment of partnership security transactions, it did so by direct amendment to Supplement F. The Senate Finance Committee investigations of Stock Exchange practices having disclosed that, during the depression years, partners of private banking houses had eliminated their personal income taxes by the application of partnership security losses against their individual incomes, Congress enacted Section 218(d) of the National Industrial Recovery Act as follows:

> Effective as of January 1, 1933, section 182(a) of the Revenue Act of 1932 is amended by inserting at the end thereof a new sentence as follows: "No part of any loss disallowed to a partnership as a deduction by section 23(r) shall be allowed as a deduction to a member of such partnership in computing net income."

In explaining the amendment, the Senate Finance Committee said (73rd Cong., 1st Sess., S. Rept. 114, p. 7):

> Subsection (d) *amends* the partnership provisions of existing law. Under *existing* law the individual members of a partnership are entitled to reduce their individual net incomes by their distributive shares of a net loss incurred by the partnership. *Your committee amendment denies nis deduction* to the extent that the net

> loss is attributable to a loss from the sale or other disposition of stocks and bonds. (Italics supplied.)

It would be difficult to phrase more clearly an intention to change the law. Yet the majority of the court below in *Johnston* v. *Commissioner,* 86 F. (2d) 732, cert. den. 301 U. S. 683, on the authority of which this case was decided, said that Section 218(d) did not change the law, but was "inserted out of abundant caution * * * and as but a clarification of existing law" (86 F. (2d) at 734).

In so holding, the court disregarded

(1) the limitation of the amendment to January 1, 1933. Presumably Congress thought the law of 1932 was to the contrary.

(2) the express statement by the Senate Finance Committee that it was making a change.*

(3) the emergency character of the National Industrial Recovery Act. This was hardly the occasion for a restatement of a minor portion of existing law as to partnership income.

(4) the purpose of the particular section to remove a newly discovered evil, as disclosed in the Senate Finance Committee Report.**

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* Where a mere restatement of prior law is intended, Congress frequently indicates that such is its intention. In the Report of the House Ways & Means Committee on the 1934 Revenue Act, for example, it is stated with respect to a proposed change in the language of §113(a)(13) (73rd Cong., 2d Sess., H. Rept. 704, p. 18):

> The committee believes that this provision embodies merely the correct interpretation of the present law, but it appears desirable to have an express statement of the rule in the statute.

** 73rd Cong., 1st Sess., S. Rept. 114, p. 5.

(5) the limited scope of the language. Section 218(d) refers only to partnership losses, not to partnership gains. This is logical, since the statute was passed to remove a particular evil, believed to exist despite Section 23(r). If the statute had been intended to restate existing law, a more comprehensive provision covering profits as well as losses would have been enacted.

In effect the majority in the *Johnston* case say that Section 218(d) was unnecessary. In view of the foregoing, this conclusion is clearly unsound.

Congress Has Indicated Its Disapproval of the Failure of the Treasury and the Court Below to Apply to Security Profits the General Rule that Items of Partnership Income Retain the Same Character on Partners' Returns as They Had on the Partnership Return.

Between the enactment of Section 218(d) in 1933 and the decision in the *Johnston* case in 1936 the Treasury ruled on the question here presented. In G. C. M. 14012, XIV-1 C. B. 145 (1935), the Treasury held that individual non-capital security losses may not be offset against partners' shares of partnership non-capital security gains. The basis of the ruling follows:

> Section 181 of the Revenue Act of 1932 provides that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. Under the "general rule" of section 182, however, the "tax of partners" is arrived at by including in the individual partners' returns their distributive shares of the partnership net income, which (under section 183) is "computed in the same manner and on the same basis as in the case of an individual, except that the so-called

'charitable contribution' deduction provided in section 23(n) shall not be allowed." In general, therefore, the items of partnership gross income and deductions do not affect a partner's income immediately as in the case of his non-partnership income, but only through the medium of the partnership return (section 189) showing his distributive share of the partnership net income or net loss (article 902, Regulations 77).

The express mention of section 184 "credits against net income," section 185 "earned income," section 186 "capital net gains and losses," and section 188 "taxes of foreign countries and possessions of the United States" as items which may directly affect the partners' net income without intervention of the partnership return emphasizes the implication that Congress intended the "general rule" of Section 182 and 183 to be otherwise an exclusive method of computing partnership income, thus limiting the exceptions to those specified (pp. 146, 147).

No reason is given for the sudden resurrection, after sixteen years, of the abandoned principle that the specification in the statute of instances in which particular types of partnership income retain identity in partners' hands precludes other types of partnership income from retaining their identity.* No reference is made to the *Coulby* case; or to G. C. M. 13771, *supra*, page 22, adopted in 1934 and applying the *Coulby* case to income from foreign sources; or to the prior consistent legislative and administrative principle of treating partnership income as retaining its identity on the partners' returns.

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*The ruling also cites cases apparently in an effort to show that for some purposes a partnership is an entity. We have already disposed of this contention (*supra*, p. 10, footnote, p. 23).

The reasoning of G. C. M. 14012 was accepted by a majority of the court below, Swan, *J.* dissenting, in the *Johnston* case. The argument thus accepted was completely demolished by Judge Swan in his dissenting opinion as follows (86 F. (2d) at 735):

> In determining taxable gains on noncapital assets, a taxpayer is allowed to offset losses on the sale or exchange of similar assets. I cannot imagine any reason why the Congress should wish to tax a man more if he made his gains in conjunction with a partner than if both gains and losses were wholly individual. Prior to the enactment of section 23(r), there was admittedly no such purpose, and a loss sustained on assets held individually could be offset against gains on assets owned in partnership. That section itself does not express an intention now to forbid it, but my brothers find such an intention in a negative implication from other sections which relate to credits against net income. To my mind those sections carry no implication against a deduction from gross income—the issue before us. They were taken over from earlier acts under which they carried no implication that a deduction of the sort now demanded was not permissible. I think it is still permissible, since the language of the new provision, section 23(r), does not forbid it. In my opinion, the order should be reversed.

Judge Swan's criticism has even more force today than in 1936 since, before the court below decided this case, Congress had already expressed its understanding of the law as petitioner urges it here. In the 1938 Act, the first general Revenue Act following the decision in the *Johnston* case, Congress provided:

Sec. 182. Tax of partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) As a part of his short-term capital gains* or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

The House Ways and Means Committee explained the changes in the partnership sections as follows (75th Cong., 3rd Sess., H. Rept., 1860, pp. 42-43):

> *The method of treatment provided in these sections of the bill is a logical corollary of the principle that only the partners as individuals, not the partnership as an entity, are taxable persons* and is necessary to give the partners as individuals the benefit of the alternative tax in the case of net long-term capital gains, provided in section 117 (c), with respect to such gains realized upon the sale or exchange of partnership capital assets. It should be noted that *this method involves a departure*

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* In distinguishing between short-term and long-term capital gains and losses, the 1938 Act in effect restored the law as it stood in 1932. As applied to securities, the term "short-term capital gains" is roughly equivalent to the term "non-capital security gains" under the 1932 Act, and the term "long-term capital gains" under Section 182(b) of the 1938 Act is roughly equivalent to the term "capital gains" as used in Section 101 of the 1932 Act. Between 1934 and 1938, all assets were treated as capital assets regardless of the time held, with a sliding scale of percentages based upon the length of the holding period.

> *from the principle adopted in the Revenue Acts of 1934 and 1936* to the extent that it enables capital *net losses* of the partnership in the respective categories to be applied, on the basis of the partners' allocable shares thereof to offset their individual capital net gains in the same categories. (Italics supplied.)

As the corollary was no more logical in 1938 than in 1932, it is clear that Congress believed that the Revenue Act at all times permitted partnership short-term security gains* to retain their identity on partners' returns. This conclusion is supported by the reference in the above quotation to the Revenue Acts of 1934 and 1936. Those Acts had continued the policy first adopted in Section 218(d) of the National Industrial Recovery Act of disallowing to partners the deduction of partnership security losses. The 1938 Act restored to partners the privilege of deducting partnership security losses. The Committee Report carefully notes the change thus made in the law. Obviously, the Committee believed it was making no change by expressly applying to partnership "short-term" (i.e., non-capital) security gains the general principle that partnership income retains its character on partners' returns.

The bearing of the 1938 Act on the present controversy is identical with that of the 1916 Act on the question in the *Coulby* case. There the issue was whether, under the 1913 Act, partners were allowed a credit against normal tax for dividends received by the partnership in the absence of specific statutory provision. The 1916 Act expressly allowed such credit. The Government argued that the later statute showed that Congress believed that the law under the earlier Act was different. The District Court rejected the argument, saying:

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* See preceding footnote.

> I do not agree with this contention. In my opinion, this provision was inserted in the 1916 Act to put at rest the present controversy, rather than to change the law, and is to be regarded only as a legislative recognition of the scope and intent of the prior law. [Citing cases, 251 Fed. at 985.]

This Court has reached a similar conclusion in dealing with the effect of other later enactments upon the interpretation of earlier Revenue Acts. *Helvering* v. *New York Trust Co.*, 292 U. S. 455; *Jordan* v. *Roche*, 228 U. S. 436.

A Majority of the Federal Courts Passing on the Question Have Held that Items of Partnership Income Retain on Partners' Returns the Same Character They Had on the Partnership Return.

Two Circuit Courts of Appeals and the Court of Claims have held squarely that partnership income retains its identity in partners' hands in the absence of specific statutory provision to that effect. *United States* v. *Coulby*, 258 Fed. 27 (C. C. A. 6); *Jennings* v. *Commissioner*, 110 F. (2d) 945 (C. C. A. 5) (pending on petition for certiorari); and *Craik* v. *United States*, 31 F. Supp. 132 (Court of Claims). Only the court below, Swan, *J.*, dissenting, in the *Johnston* case,* *supra*, pp. 28-31, and the Court of Claims, in a case which followed the *Johnston* case and which was decided before the *Craik* case, have accepted the reasoning of G. C. M. 14012, *Klingenstein* v. *United States*, 18 F. Supp. 1015.**

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* The Second Circuit followed the *Johnston* case in *Winmill* v. *Commissioner*, 93 F. (2d) 494, reversed on another point, 305 U. S. 79, and in several *per curiam* decisions.

** The Court of Claims followed the *Johnston* and *Klingenstein* cases in *Mosbacher* v. *United States*, 30 F. Supp. 703, pending on petition for certiorari, which was decided before the *Craik* case, *supra*.

The *Coulby* case has been fully discussed, *supra,* pp. 13-16. Its importance cannot be too greatly stressed, in view of its unquestioned acceptance by the Treasury in a series of rulings promulgated over a span of sixteen years (*supra,* p. 14).

In the *Jennings* case, *supra,* the taxpayer sought to offset individual gambling losses against her share of partnership gambling gains. Section 23(g) of the 1936 Revenue Act provided that losses from wagering transactions are allowable only to the extent of gains from such transactions, just as Section 23(r) of the 1932 Act provided that non-capital security losses are allowable only to the extent of non-capital security gains. There was no provision in the 1936 Act that partnership wagering gains retain their identity in partners' hands, just as there was none in Supplement F of the 1932 Act regarding partnership non-capital security gains. The Treasury and the Board of Tax Appeals held against the taxpayer, following the *Johnston* case. G. C. M. 21478, 1939-2 C. B. 159; B. T. A. Memo., Docket No. 94529, July 25, 1939. The Fifth Circuit reversed by a divided court, Judge Sibley saying:

> A partnership is recognized as an entity separate from the partners in bankruptcy proceedings, but not in income taxation. *United States* v. *Coulby,* 6 Cir., 258 F. 27. For many years the Revenue Acts have provided that "individuals carrying on business in partnership shall be liable for income tax only in their individual capacity." Revenue Act of 1918, §218(a), 40 Stat. 1057, 1070, Revenue Act of 1936, §181, 49 Stats. 1648, 1709, 26 U. S. C. A. Int. Rev. Code, §181. Thereunder a tax on income earned in partnership was held not a claim against the partnership in bankruptcy, and it went unpaid for lack of individual assets. *United States*

> v. *Kaufman,* 267 U. S. 408, 45 S. Ct. 322, 69 L. Ed. 685. The partnership return is for information, and to secure uniformity and save repetition in the individual returns. It ascertains each partner's gain and apportions it to him to be taxed, whether distributed or not. It does not transform his share in the gain. If "individuals carrying on business in partnership," to use the phrase of the statute, make gains in wagering transactions, the share of each is a wagering gain; and when it is entered on his individual return to be taxed, a deduction of his losses in other wagering transactions is allowed by the statute, but only to the extent of such gains.

Referring to the *Johnston* case, Judge Sibley continued:

> We are impressed that the dissenting judge was probably right, but that case dealt with a different statutory provision, and it had been amended by Congress, the purpose of the amendment being one of the disputed points (110 F. (2) at 946).

The amendment to which the Fifth Circuit refers is Section 218(d) of the National Industrial Recovery Act, discussed *supra,* pp. 27-29. That amendment did not apply to 1932, the year in question here, and it dealt with the converse of the question in this case, i. e., whether partnership security losses may be offset against individual security profits. We have demonstrated (*supra,* pp. 27-29) that Section 218(d) supports our view that under the 1932 Act partnership security gains retain their identity on partners' returns.

In *Craik* v. *United States,* 31 F. Supp. 132, the Court of Claims held that a non-resident alien member of a domestic partnership was not taxable on his distributive share of in-

come derived by the partnership from sources without the United States, although the applicable Acts were silent as to the right of a non-resident alien partner to such exclusion. Whitaker, *J.* wrote:

> An examination of the various income tax Acts, beginning with the first one of 1913, shows that Congress in the enactment of each of them intended to treat partnership income as though the distributive share of each partner therein had been received directly by the partner (p. 133). * * *
>
> The treatment of partnership income on the same basis as though it had been received by the partner directly is consistent with the common-law idea of a partnership (p. 134). * * * The income earned by the partnership was regarded as having been earned by each of the individual partners, either by himself individually or through his agents, the other partners.
>
> The Bureau of Internal Revenue has so treated partnership income for twenty years. Originally it promulgated a regulation providing that partnership income could not be traced to its source behind the partnership for the purpose of claiming individual exemption. This ruling, however, was questioned and presented to the District Court for the Northern District of Ohio. On June 26, 1918, the court rendered an opinion holding that the Revenue Acts treat a partnership's "* * * profits and its earnings as those of the individual taxpayer. * * * The Congress, consequently, it would seem ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name." *United States* v. *Coulby,* D. C.,

> 251 F. 982, 984. This case was affirmed on appeal. *United States* v. *Coulby,* 6 Cir., 258 F. 27.
>
> It is admitted that since this time partnership income has been so treated by the Bureau. In the light of this administrative practice Congress has continued to enact substantially the same provisions for the treatment of partnership income (pp. 134, 135).

In the *Craik* case, the Court of Claims attempted to distinguish the *Johnston* decision. The attempt is hollow. Read as a whole, the opinion in the *Craik* case cannot be squared with the *Johnston* decision. The Court of Claims said (31 F. Supp. at 135):

> The Court (in the *Johnston* case) thought that Congress by providing for certain specific credits against a partner's income on account of his share of partnership profits, thereby impliedly prohibited any other credit. The Court called attention to the fact that the Act expressly provided for taxing the partners on their distributive share of capital net gains as if it had been received by them individually, and thought that its failure to mention noncapital gains and losses indicated that it did not intend that they should be treated similarly. This case was followed by this court in *Klingenstein* v. *United States,* 85 C. Cls., 164; 18 F. Supp. 1015.
>
> Congress' attention having been given to gains and losses, and having provided for the treatment of capital gains and losses as if they were the gains and losses of the individual partners, and not having made such provision for noncapital gains and losses, there was room for the conclusion reached in the *Johnston* case, *supra.*

Having said so much, the Court proceeded to demolish its support of the *Johnston* case as follows (31 F. Supp. at 135-6):

But we do not think that by the specification of certain items for which the partner might take credit Congress intended to exclude all others, if the exclusion of them would result in the treatment of partnership income in a way different from what it would have been treated had it been received by the partners individually.

It is, of course, within the power of Congress to limit deductions from gross income to any extent it pleases, but our study of the pertinent sections of the 1916 and 1918 Acts and of related sections of other acts persuades us that Congress intended that an individual should have every deduction from partnership income which he might take from his individual income, unless the contrary clearly appears.

However, we are dealing here not with what credits or deductions a partner is entitled to, but what he shall include in his gross income. We are convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually. If we are correct in this, then this plaintiff's proportionate share of the partnership income received from sources without the United States should be treated as though he himself had received this income directly, and not through the conduit of the partnership. If so, in computing his income, his proportionate share of the income from sources without the United States should be excluded.

The defendant further takes the position in its brief that the plaintiff received his income from the partnership, and since the partnership was a "domestic partnership" his income was from sources within the United States, from whatever source the income might have been derived by the partnership. This cannot be true unless the partnership is regarded as a separate entity,

and this the Revenue Act does not do. (*Cf. Dorothy S. Bence* v. *United States,* 84 C. Cls., 605; 18 F. Supp. 848.)

If the *Johnston* case correctly held that a partner should not be given credit for his share of specific items of partnership income except where the Revenue Act expressly so provides, the Court of Claims could not have held for the plaintiff in the *Craik* case, since there was no specific provision in the Acts before that Court giving a non-resident alien partner credit for his share of the partnership's foreign income, while there were specific provisions in those Acts giving a partner credit for his share of other kinds of partnership income (dividends and Government bond interest). Apparently the Court of Claims was embarrassed by its earlier decision in the *Klingenstein* case, which followed the *Johnston* case, and preferred to restrict its scope rather than overrule it in a case which did not present the same narrow issue.

The Government has not applied for certiorari in the *Craik* case, although before the time for such application had expired, petitioner had asserted a conflict between the decision below and the *Craik* case, in support of the petition for certiorari here. Presumably, therefore, as to partnership income from foreign sources, the Government still adheres to the view expressed in G. C. M. 13771, XIII-2 C. B. 229, *supra* p. 22, and to the general principle of the *Coulby* case upon which that ruling was based.

To summarize: Taxation of partnership income since 1913 has been guided by the general principle that items of partnership income retain their character on partners' returns, whether or not the statute so provides. Section 23(r) of

the 1932 Act was not intended to change this principle. Hence, petitioner is entitled to the claimed offset.

But if there be any uncertainty as to the construction of the statute, it should be resolved in petitioner's favor to avoid the grave constitutional doubts presented by a contrary construction.

POINT II.

Section 23(r) of the Revenue Act of 1932 is unconstitutional if construed to deny to petitioner offset of his non-capital security losses against his distributive share of partnership non-capital security gains, petitioner being engaged in the business of trading in securities for his own account and for his partnership.

If the Court holds that Section 23(r) prevents the offset of petitioner's non-capital security losses against his share of his partnership's non-capital security gains, the Section is arbitrary and discriminatory in violation of the due process clause of the Fifth Amendment,* since it deprives petitioner of the offset merely because (1) his non-capital security gains were earned through a partnership, and (2) he traded in stocks and bonds as distinguished from other speculative media.

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* This Court has intimated that an income tax law may be so arbitrary and discriminatory as to violate the Fifth Amendment. *Brushaber* v. *Union Pacific R. R.*, 240 U. S. 1, 24; *Barclay & Co.* v. *Edwards*, 267 U. S. 442, 450; *Denman* v. *Slayton*, 282 U. S. 514, 520; *Reinecke* v. *Smith*, 289 U. S. 172, 177.

The court below in *Davis* v. *United States,* 87 F. (2d) 323, cert. den. 301 U. S. 704,* upheld the constitutionality of Section 23(r) in a case where the taxpayer, a casual investor, sought to offset non-capital security losses from isolated transactions against ordinary income which did not include non-capital security gains, saying (pp. 324, 325):

> It will be well to note at the start that our scheme of income taxation provides for a method of computation whereby all receipts during the taxable period which are defined as gross income are gathered together and from the total are taken certain necessary items like cost of property sold; ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion, and the like in order to reduce the amount computed as gross income to what is in fact income under the rule of *Eisner* v. *Macomber,* 252 U. S. 189, and so lawfully taxable as such. In this way true income is ascertained by taking from gross income as defined that which is necessary as a matter of actual fact in order to determine what as a matter of law may be taxed as income. While such subtractions are called deductions, as indeed they are, they are not to be confused with deductions of another sort like personal exemptions; deductions for taxes paid; losses sustained in *unrelated* transactions and other like privileges which Congress has seen fit to accord to income taxpayers

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* The *Davis* case was followed by the Court of Claims on similar facts in *Cohn* v. *United States,* 23 F. Supp. 534. *In Winmill* v. *Commissioner,* 93 F. (2d) 494, the Government argued that the question whether Section 23(r) is constitutional as applied to a trader was not presented since the Board of Tax Appeals had not found that Winmill was a security trader (Gov. Br. pp. 22-3). The Second Circuit followed the *Davis* case without discussion of the constitutional question presented by petitioner here.

under classifications it has established. While the first kind of deductions are inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress; the only restriction being that it does not act arbitrarily so as to set up in effect a classification for taxation so unreasonable as to be a violation of the Fifth Amendment. Such deductions as distinguished from the first kind are allowed by Congress wholly as a matter of grace. * * *

The loss which the appellant tried to deduct from his *unrelated* income falls within the second class of deductions of which mention has been made, and so its limitation as in section 23(r) was one which Congress could control in its sound discretion without in substance levying a direct tax without apportionment. (Italics supplied.)

The basis of this decision was that the losses were unrelated to taxpayer's income. Davis was not engaged in the business of trading in securities, nor was he entitled to a distributive share of partnership non-capital security profits in excess of his own non-capital security losses. Since this petitioner's security losses and his share of partnership security gains came from a single business, they were related, and under the reasoning of the *Davis* case, the application of the statute here is unconstitutional.

Discrimination Against Petitioner Because His Profits Were Realized in Partnership Is Unconstitutional.

The constitutional test which must be met by a Federal tax law has been recently defined by this Court as follows:

Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The test of validity in re-

> spect of due process of law is whether the means adopted are appropriate to the end. * * * But if the means are unnecessary or inappropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guarantee of due process is infringed. (*Helvering* v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 90.)

Thus the question is whether the application of Section 23(r) to the facts here presented bears a reasonable relationship to the purpose of its enactment.

Had petitioner realized individually his share of his firm's non-capital security gains, the setoff which he is seeking would be allowed without question. Since the setoff has been denied, petitioner is discriminated against merely because his profits were realized in partnership, rather than individually.

Such discrimination bears no relationship to the object of Section 23(r). We have already demonstrated that the sole purpose of Section 23(r) was to prevent the deduction of speculative security losses from salaries, dividends, rents, interest and other similar income. *Supra*, pp. 24-27. There was no intention to deprive partners of the right to offset individual speculative security losses against distributive shares of partnership speculative security gains.

But even if such intention be assumed, we submit that a discrimination against partners in the application of Section 23(r) is so arbitrary and unreasonable as to be unconstitutional. There can be no possible justification for such unequal treatment.

The discrimination is all the more unfair because petitioner realized the profits and sustained the losses in the course of his single business of trading in securities. To segregate the profits from such single business and subject them to special taxation merely because they were derived through a partnership is highly arbitrary.

Further, petitioner had no notice at any time during the tax year 1932 that the continued conduct of part of his business through the medium of a partnership would result in additional taxes. This is not a case where there was an established policy of Congress, knowledge of which was chargeable to the taxpayer. On the contrary, the long established policy of Congress accorded to persons doing business in partnership the same right of taking deductions against partnership income as though the business were conducted individually. *Craik* v. *United States,* 31 F. Supp. 132, 135, quoted *supra,* p. 39.

Discrimination Against Petitioner Because His Business Was Trading in Corporate Securities Is Unconstitutional.

Section 23(r) does not apply to all speculative transactions, but only to transactions in assets defined in Section 23(t), which limits the operation of the Section to stocks and bonds held less than two years, except Government securities. The court in the *Davis* case did not discuss the discrimination against traders in stocks and bonds, but said only that Congress was justified in restricting the availability of security losses against ordinary income to losses on securities held more than two years.

The discriminatory effect of the special treatment of stocks and bonds is illustrated by a series of hypothetical cases:

A, a trader in United States Government bonds, bought $100,000 of such bonds at par in 1931 and sold them for $95,000 in 1932. The $5,000 loss is deductible from ordinary income (I. T. 2672, XII-1 C. B. 72, 73).

B, a trader in foreign government bonds, bought $100,000 of such bonds at par in 1931 and sold them for $95,000 in 1932. The $5,000 loss is deductible from ordinary income (I. T. 2671, XII-1 C. B. 41).

C, a real estate trader, bought a parcel in 1931 for $100,000 and sold it in 1932 for $95,000. The $5,000 loss is deductible from ordinary income (I. T. 2671, XII-1 C. B. 41, 43).

D, a trader in commodity futures, bought wheat contracts in 1931 for $100,000 and sold them in 1932 for $95,000. The $5,000 loss is deductible from ordinary income (I. T. 2774, XIII-1 C. B. 62).

E, a trader in mortgages, bought one in 1931 for $100,000 and sold it in 1932 for $95,000. The $5,000 loss is deductible from ordinary income (I. T. 2671, XII-1 C. B. 41, 43).

F, a trader in corporate stocks and bonds, bought a block of such securities in 1931 for $100,000 and sold them in 1932 for $95,000. The loss of $5,000 is not deductible from ordinary income, and not deductible at all unless F had realized gains of $5,000 from transactions in such securities held less than two years, in which case the loss of $5,000 may be offset against the gains.

In each of the first five cases, the trader is permitted to recoup his loss in part by taking a [illegible] deduction with resultant tax saving. In the sixth c[illegible]he stock and bond trader is not permitted such reco[illegible]nt.

Except perhaps in the case of Government bonds, there is no justification for this discrimination, since in each of the six cases the taxpayer is a speculator as defined by the Senate Finance Committee which drafted Section 23(r) (*supra,* pp. 25-26), having held the asset for less than two years.

In the case of A, the trader in Government bonds, the discrimination was deliberate. The reason was given by the Ways and Means Committee (72nd Cong., 1st Sess., H. Rept. 708, p. 13):

> Federal, State, and municipal bonds are excluded from the definition so as not to hamper the sales of such securities. Bonds of foreign governments are also excluded.

The desire to facilitate sale of Government bonds may justify the exclusion of Government bonds from a loss-limiting provision. But even in this respect, Section 23(r) is capricious, since it taxes a Government bond trader on profits although he has losses on other securities held less than two years. *Charles J. Bradley,* 41 B. T. A. 153. In this situation, instead of facilitating the sale of Government bonds, the statute singles out Government bond profits for taxation despite losses on securities held the same length of time which are deductible from corporate security profits.

But the desire to facilitate the sale of Federal, State and municipal bonds does not justify the exemption of the trader in foreign government bonds. There is no reason why a salaried person may reduce the tax on his salary by losses in an unsuccessful speculative venture in foreign government bonds, but not by losses on sales of American corporate securities.

There is also no justification for discriminating in favor of D, the trader in commodity futures. It does not appear that Congress desired to favor speculators in commodity futures as against speculators in corporate securities. On the contrary, the congressional policy to discriminate against commodity traders by tax measures was announced as early as 1913. 63rd Cong., 1st Sess., S. Rept. 80, 1939-1 C. B. (Part 2) 5; Cotton Futures Act (1914), 38 Stat. 693, 26 U. S. C. A. §1920.

Nor is the discrimination against F justifiable on the ground that speculative stock losses constituted a menace to the revenue. During the depression, deduction of huge speculative losses from dealings in real estate, mortgages and commodity futures, constituted no less a menace.

It is also obvious that, as a matter of administration, provisions limiting the deductibility of losses from speculative transactions not involving stocks and bonds would have created no greater problem than did Section 23(r).

Indeed, Section 23(r) was in force for only two years, 1932 and 1933. Between 1924 and 1932, dealings in all types of assets held similar lengths of time were on an equal footing. Section 117 of the Revenue Act of 1934 restored equality of treatment to all types of assets, and this has continued to be the rule under the later Acts, except that since 1938 somewhat more liberal treatment has been accorded to depreciable assets used in business.

Thus, in dealing with the discrimination directed by the 1932 Act against traders in stocks and bonds, the Court is dealing, not with an established legislative policy of long standing, but with a new and experimental provision, abandoned after only two years of operation.

Constitutional questions are questions of degree. The question is whether the denial of the offset on the facts of this case is so unreasonable and unjustified as to shock one's sense of fairness. In judging this question, we submit that it is of vital importance that petitioner was engaged in the business of trading in securities. It is arbitrary beyond the bounds of reasonableness to tax a trader on his income from one phase of his business without allowing deduction of his losses from another phase of the same business where both profits and losses resulted from the same type of activity, security trading, and where the announced policy is to permit the offset of such losses to individuals, on the one hand, and to permit unlimited deduction to traders in all types of assets other than corporate securities, on the other.

If the Court holds Section 23(r) unconstitutional, petitioner is entitled to deduct his individual non-capital security losses under Section 23(e)(1) of the Revenue Act of 1932, permitting deduction of losses incurred in trade or business.

CONCLUSION.

The decision below resulted from the refusal of the court to recognize the principle which has been basic in taxation of partnership income since 1913, namely, that partnership income may be traced to its source behind the partnership for the tax purposes of the individual partners whether or not the statute specifically so provides. Section 23(r), on which the court relied, was enacted for a specific purpose and was not intended to change this principle. The construction adopted by the court below was therefore wrong.

Construed as it was by that court, Section 23(r) exceeds the limits of reasonableness and enters the area of arbitrary action proscribed by the Fifth Amendment.

The decision below should be reversed.

Respectfully submitted,

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September, 1940.

APPENDIX.

Statutes Involved.

Section 8(e) of the Revenue Act of 1916 provides in part:

> Persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid under the provisions of this title: *Provided,* That from the net distributive interests on which the individual members shall be liable for tax, normal and additional, there shall be excluded their proportionate shares received from interest on the obligations of a State or political or taxing subdivision thereof, and upon the obligations of the United States and its possessions, and all taxes paid to the United States or to any possession thereof, or to any State, county, or taxing subdivision of a State, and that for the purpose of computing the normal tax there shall be allowed a credit, as provided by Section 5, subdivision (b), for their proportionate share of the profits derived from dividends.

The Revenue Act of 1932 provides in part as follows:

> Sec. 22. Gross income. * * *
>
> (b) Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this Title. * * *
>
> (4) Tax free interest.— * * * In the case of obligations of the United States issued after September 1,

1917 (other than postal savings certificates of deposit), the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from the taxes imposed by this title;

[Section 22(b)(4) of the 1928 Act was similar.]

Sec. 23. Deductions from gross income.

In computing net income there shall be allowed as deductions:

* * * * *

(e) Losses by individuals.—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) If incurred in trade or business; or

(2) If incurred in any transaction entered into for profit, though not connected with the trade or business; * * *.

(r) Limitation on stock losses.—

(1) Losses from sales or exchanges of stocks and bonds (as defined in subsection (t) of this section) which are not capital assets (as defined in section 101) shall be allowed only to the extent of the gains from such sales or exchanges (including gains which may be derived by a taxpayer from the retirement of his own obligations).

(2) Losses disallowed as a deduction by paragraph (1), computed without regard to any losses sustained during the preceding taxable year, shall, to an amount not in excess of the taxpayer's net income for the taxable year, be considered for the purposes of this title as losses sustained in the succeeding taxable year from sales or exchanges of stocks or bonds which are not capital assets.

(3) This subsection shall not apply to a dealer in securities (as to stocks and bonds acquired for resale to customers) in respect of transactions in the ordinary course of his business, nor to a bank or trust company incorporated under the laws of the United States or of any State or Territory, nor to persons carrying on the banking business (where the receipt of deposits constitutes a major part of such business) in respect of transactions in the ordinary course of such banking business. * * *

(t) Definition of Stocks and Bonds.—

As used in subsections (r) and (s), the term "stocks and bonds" means (1) shares of stock in any corporation, or (2) rights to subscribe for or to receive such shares, or (3) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation (other than a government or political subdivision thereof), with interest coupons or in registered form, or (4) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of the instruments mentioned or described in this subsection, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

Sec. 101. Capital net gains and losses. * * *

(c)(8) "Capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business. * * *

[Sections 101(c)(8) of the 1928 Act, and 208(a)(8) of the 1924 and 1926 Acts, were similar.]

Sec. 143. Withholding of tax at source.

(a) Tax free covenant bonds.—

(1) Requirement of withholding.—In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to an individual, a partnership, * * *

(d) Income of recipient.—Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall

be credited against the amount of income tax as computed in such return.

[Section 144(a)(1) and (d) of the 1928 Act was similar.]

Supplement F of the 1928 and 1932 Acts, entitled "Partnerships," provides in part:

Sec. 181. Partnership Not Taxable.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

Sec. 182. Tax of Partners.

(a) *General Rule.*—There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. * * * [Provisions dealing with partnership fiscal years are omitted.]

Sec. 183. Computation of Partnership Income.

The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except that the so-called "charitable contribution" deduction provided in section 23(n) shall not be allowed.

Sec. 184. Credits Against Net Income.

The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts of dividends and

interest specified in section 25(a) and (b) as are received by the partnership.

Sec. 185. Earned Income.

In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership and shall be taxed to the member as provided in this Supplement.

Sec. 186. Capital Net Gains and Losses.

In the case of the members of a partnership the proper part of each share of the net income which consists, respectively, of ordinary net income, capital net gain, or capital net loss, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership and shall be taxed to the member as provided in this Supplement, but at the rates and in the manner provided in section 101(a) and (b), relating to capital net gains and losses.

Sec. 187. Net Losses.

The benefit of the special deduction for net losses allowed by Section 117 shall be allowed to the members of a partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

Sec. 188. Taxes of Foreign Countries and Possessions of United States.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the

tax of the member of a partnership to the extent provided in Section 131.

Sec. 189. Partnership returns.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

Supplement H—Non-resident alien individuals:

Sec. 211. Normal tax.

(a) *General rule.*—In the case of a non-resident alien individual who is not a resident of a contiguous country, the normal tax shall be 8% of the amount of the net income in excess of the credits against net income allowed to such individual. * * *

Sec. 212. Gross income.

(a) *General rule.*—In the case of a non-resident alien individual gross income includes only the gross income from sources within the United States.

[Sections 211 and 212 of the 1928 Act were similar.]

The Revenue Act of 1934 provided in part:

Sec. 113. Adjusted basis for determining gain or loss.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

(13) Partnerships.—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any of the paragraphs (1) to (12), inclusive, of this subsection,

then the basis shall be the same as it would be in the hands of the transferor, * * *.

Sec. 117. Capital gains and losses. [Identical with Sec. 117(b) of the 1936 Act.]

* * * * *

(b) Definition of capital assets.—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The Revenue Act of 1938 provided in part:

Sec. 117. Capital gains and losses.

(a) Definitions.—As used in this title—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l); * * *.

(2) Short-Term Capital Gain.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, * * *.

(4) Long-Term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, * * *."